87-SBE-037

BEFORE THE STATE BOARD OP EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 85A-888-VN
ROBERT J. AND JAN W. MORLEY)

For Appellant: John F. McKenna, Jr.
Mohle, Thomas & Marshall
Accountancy Corporation

For Respondent: B. (Bill) S. Beir
Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Robert J. and Jan W. Morley against a proposed assessment of additional personal income tax in the amount of $1,155 for the year 1980.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

Appeal of Robert J. and Jan W. Morley

The question presented for our decision is whether Robert J. and Jan W. Morley were entitled to the full amount of their claimed partnership loss deduction for research and development expenditures. Since Mrs. Morley is a party to this appeal only because she filed a joint income tax return with her husband, we shall refer to Robert J. Morley as "appellant" for purposes of this appeal.

In 1980, appellant organized a limited partnership, Radio Time Company, for the production of short entertainment programs that were to be sold to radio broadcast stations. The limited partnership consisted of appellant, as both the general and a limited partner, and seven other limited partners. Each partner contributed $53,200 in cash and a promissory note for $6,000 in favor of the partnership.[2]

On December 26, 1980, appellant executed a demand note promising to pay Radio Time Company the sum of $12,000 in 16 quarterly installments. In the alternative, the partnership had the option of collecting payments from one-half of appellant's "net revenues" from the partnership. (Resp. Br., Ex. C.) On December 31, 1980, appellant made a cash contribution of $1,400 and signed a $5,000 promissory note payable to the partnership on March 31, 1981.

Sometime during the appeal year, the partnership entered into a contract with Sunbelt Network, Inc., (Sunbelt) of Dallas, Texas, for the development and marketing of radio programs. Under the terms of the agreement, the partnership allegedly advanced Sunbelt $31,000 in cash and tendered $60,000 worth of promissory notes executed by the partners. For its cooperation, the partnership acquired the right to receive from Sunbelt 40 percent of the gross revenues from Sunbelt's sale or distribution of programs that it had developed and 50 percent of the gross revenues from Sunbelt's sale or distribution of programs that were developed by third parties. On April 7, 1981, appellant paid $5,000 to Sunbelt, thereby discharging his obligation under the

2/ While the partnership return indicates that the partnership received $92,000 in capital contributions in 1980, the record is not clear as to the total amounts of either the cash contributions of the partners or the promissory notes executed by the partners.

$5,000 promissory note. Appellant failed, however, to make any payments towards the $12,000 promissory note.

On a partnership return of income for its income year ending December 31, 1980, Radio Time Company reported capital contributions of $92,000 and a loss of $91,260. At the end of the year, $740 thus remained in the capital account, The loss was largely due to the $91,000 expenditure paid to Sunbelt for alleged research and development costs which was deducted as a business expense. Appellant's distributive share of this partnership loss was $18,982 which he then claimed on his and his wife's joint return for 1980.

On review, the Franchise Tax Board determined that appellant's claimed partnership loss exceeded the adjusted basis of his interest in the partnership, (Rev. & Tax. Code, § 17858, subd. (a).) Pursuant to section 17599 which limits a taxpayer's loss to the amount that he has "at risk" and section 17882 which provides that the basis of a partnership interest acquired by a contribution of money is the amount of such contribution, respondent initially determined that the basis of appellant's interest consisted only of his $1,400 cash contribution. Subsequently, in an attempt to settle this matter with appellant, respondent agreed to increase his basis by the $5,000 payment that he made on the promissory note in April 1981, but disallowed the $12,582 of partnership loss that exceeded this revised $6,400 basis. Respondent then issued the subject deficiency assessment, but appellant reneged on an agreement not to contest the assessment, and this appeal followed.[3/]

In this appeal from the action of' the Franchise Tax Board, appellant argues that he should have been allowed the full amount of his claimed partnership loss

3/ For the year in question, section 17858 provided that a "partner's distributive share of partnership loss (including capital loss) shall be allowed *only* to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred." (Emphasis added.) We realize, however, that the Franchise Tax Board allowed the $5,000 increase to appellant's basis, even though the payment on the note was made after the year in question, only because respondent believed after negotiations with appellant that he would not contest the resultant assessment.

from Radio Time Company since he was "at risk" for all sums invested in the partnership, including the unpaid $12,000 promissory note that was not considered by respondent to be part of the basis of his partnership interest. Respondent, on the other hand, has made several arguments in support of its partial disallowance of appellant's partnership loss. However, to resolve this appeal, we need only to discuss respondent's argument regarding the deductibility of research and development expenses.

In general, taxpayers may not deduct capital expenditures in a single taxable year. (Rev. & Tax. Code, § 17283.) One of the exceptions to this rule is research and experimental expenditures (Appeal of Arnold L. and Edith M. Hunsberger, Car: St. Bd. of Equal., Jan. 8, 1980.) Section 17223, subdivision (a) (1), provides:

> A taxpayer may treat research and experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

This section is substantially similar to its federal counterpart, section 174 of the Internal Revenue Code. Since the Franchise Tax Board has not issued any regulations interpreting the state law, regulations promulgated under the Internal Revenue Code would govern the interpretation of the conforming state statute. (Appeal of Peter Lavalle, Cal. St. Bd. of Equal., Feb. 5, 1985.) Moreover, the interpretations and effect given the federal provision by the federal courts are relevant in determining the meaning of the California statute. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

Treasury Regulation section 1.174-2, subdivision (a) (1), defines research and experimental expenditures as "expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense." The term includes all such costs incident to the development of an experimental or pilot model, or product, or formula, but it does not include expenses paid or incurred for research in connection with literary or historical projects. (Treas. Reg. § 1.174-2, subd. (a)(1).)

The provisions of Internal Revenue Code section 174 apply both to costs paid or incurred by the taxpayer for research undertaken directly by him, as well as to expenditures paid or incurred for research carried on in the taxpayer's behalf by another person or organization. (Treas. Reg. § 1.174-2, subd. (a)(2).)

In Snow v. Commissioner, 416 U.S. 500 [40 L.Ed.2d 336] (1974), the Supreme Court stated that section 174 was enacted in 1954 with the legislative purpose of encouraging expenditures for research not only by large, ongoing firms but also by small, pioneering companies that did not have established research departments. Moreover, based on the use of the phrase "in connection with a trade or business" in section 174, the court concluded that Congress intended that research expenses be deductible even though a taxpayer may not be currently engaged in the production or sale of a product or service.

Subsequently, the tax court in Green v. Commissioner, 83 T.C. 667 (1984), opined that the Supreme Court had not entirely eliminated the trade or business requirement of section 174. To qualify research expenses for deduction under section 174, the tax court stated that "the taxpayer must still be engaged in a trade or business at some time . . . ." (Green v. Commissioner, supra, 83 T.C. at 686-687.) Whether the taxpayer's activities from which the deductions arose are sufficiently substantial and regular to constitute a trade or business is a question of fact. (Cf. Higgins v. Commissioner, 312 U.S. 212 [85 L.Ed. 383] (1941); Ditunno v. Commissioner, 80 T.C. 362 (1983).) An actrvrty does not constitute a trade or business unless it is engaged in with the predominant motive of making a profit. (Flowers v. Commissioner, 80 T.C.914, 931 (1983).) The management of investments, however, is not a trade or business, regardless of the extent of the investments or the amount of time required to perform the managerial functions. (Green v. Commissioner, supra, 83 T.C. at 688; Appeal of Homer V. Burkleo, et al., Cal. St. Bd. of Equal., Nov. 19, 1986.)

Deductions are a matter of legislative grace and the taxpayer bears the burden of showing that he is entitled to the deduction claimed. (New Colonial Ice co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).) Applying the foregoing principles to the present matter, we find that appellant has not proven that Radio Time Company was engaged in a trade or business. Appellant

has alleged that the partnership was in the business of producing and marketing radio programs, but he has not presented any evidence demonstrating that the partnership at any time actually engaged in the development of radio programs much less possessed the ability to conduct such activities. We further observe that the address of Radio Time Company as reflected on the partnership return was the same as that of the accountant who prepared the return.

While the partnership did invest capital in Sunbelt for the production of radio programs, the partnership, under that so-called development contract, acquired only a royalty interest in the programs and the amount of royalties depended on the marketing and sales efforts of Sunbelt. In other words, Radio Time Company did not have au ownership interest in an audio product nor control over the production or marketing of any programs. Therefore, like the partnership in Green v. Commissioner, supra, Radio Time Company appears to have been merely an investor whose sole activities in the appeal year consisted of providing funds to another company for the right to collect royalties at a later date.

Based on the record, we must find that appellant has not shown that Radio Time Company was engaged in a trade or business. It follows, therefore, that any alleged research or experimental expenses claimed by the partnership were not incurred "in connection with" a trade or business. Accordingly, appellant as a partner was not entitled to deduct any part of his distributive share of the partnership loss attributable to the research and experimental expenses.[4] Respondent's action in this matter shall be sustained.

4/ Because we have decided that the partnership was not engaged in a trade or business, it is not necessary to discuss whether the costs in question qualified as research or experimental expenses within the meaning of the statute.

Appeal of Robert J. and Jan W. Morley

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Robert J. and Jan W. Morley against a proposed assessment of additional personal income tax in the amount of $1,155 for the year 1980, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of May , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis , Chairman

Ernest J. Dronenbura. Jr. , Member

William M. Bennett , Member

Paul Carpenter , Member

Anne Baker* , Member

*For Gray Davis, per Government Code section 7.9